

Greater Washington Society of CPA's  
Educational Foundation  
Non-Profit Accounting Basics

## Internal Controls for Small Organizations

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### General Controls

- Involve as many people as possible.
- Use only pre-numbered checks.
- Use accounting software to print checks if at all possible.
- Keep all unused checks in a *locked* cabinet or closet.
- Limit the number of people with access to the checks.
- Limit check signers to trustees and management.
- Pay only from invoices. Do not process statements from vendors.
- NEVER pay a vendor without a valid invoice or contract.
- Mark invoices "paid" to avoid duplicate payments.
- Follow the same procedures for wire transfers as for checks.
- Someone other than the person writing the check should review the documentation and sign the check.
- Require two signatures for amounts above a set threshold. When setting the amount consider:
  - A set dollar amount.
  - Whether certain checks can be excluded from the requirement. For example, a set amount is paid for rent each month based upon a signed lease. As long as the rent is for the amount noted in the lease, a second signature is not required.
- Consider the "positive pay" program now being offered by most banks. The organization submits a list of checks written on any particular day to the bank. The bank will then take responsibility for ensuring duplicate check numbers with different payees are not processed. It should be noted that this service can be relatively expensive, so it may not be appropriate for all organizations.
- Someone other than the person writing and mailing the checks should receive the unopened bank statement and review the contents before it is reconciled.

### Writing Checks

The more people involved in processing transactions, the less likely it is that a problem will occur. For small organizations with limited staffing, this issue is particularly troublesome. In some cases, the best answer lies in having members of the board of directors serve as check signers. This option is usually most viable if there are several board members living in the area of the organization's office.

At a minimum an organization should have two people involved in this process. The process can be broken into several parts with only two people involved:

- The mail is opened by administrator.
- The invoice is checked for accuracy by the administrator.
  - Does it add?
  - Does it match the packing information if the items were delivered?
  - Does the price match the contract?
- The invoice should be coded by type of account and department/program/grant by the person who ordered the service and/or has responsibility for the budget being charged.
  - For example, an invoice for supplies for the conference should have a notation to that effect on the invoice.
- The person who authorized the purchase or service should approve the invoice in writing, preferably on the invoice.
- The check should be written by the administrator.
  - If a computerized system is used, the check writing should be automated.

- If a manual check is written, an entry should be made into the accounting system (general ledger).
- The unsigned check and the supporting documentation should be given to the check signer (manager).
  - The signer should be someone other than the person writing the checks.
- The checks should then be mailed.
- A copy of the check should be attached to the invoice and filed by the administrator.
  - As an alternative, the check number can be written on the invoice.
    - In this case, the invoice should be marked as paid.

## WIRE TRANSFERS

The processing of the request for payment is the same whether writing checks or making wire transfers. However, the method of making the payment differs.

When making a wire transfer, all of the documentation and authorizations necessary for any disbursement should be obtained prior to making the transfer. Further, a wire transfer form should be developed showing:

- The payee
- The name of the payee's bank
- The account number for the payee
- The amount of the wire
- The date the transfer takes place
- The initials of the person making the transfer
- The initials of the person(s) authorizing the transfer

These transfers can be requested in person at the bank, by telephone call or online.

Transfers made online appear to provide the highest level of control. The program can be set-up in a manner that requires one or more approvals before the transfer will be released. For example, one employee will input the transaction. A second, and perhaps a third employee, will review the transaction. The second and third employee will have authorization codes that will need to be posted before the transaction will be released. This process ensures that the transaction has been properly authorized **prior** to its taking place.

## Deposits

If possible, have an individual outside of the accounting department open the mail. This individual should make a list of the checks received prior to forwarding the checks to the accounting department.

If a large amount of cash (as opposed to checks) is received, two people should always open the mail. In cases where an event is held, two people should always be present at each site where cash is collected.

The organization should have a "For deposit only" stamp. The stamp should also include the organization's name. Every check received should be stamped prior to deposit.

A deposit slip should be prepared listing all checks.

Copies of the checks deposited are often kept as support for the deposit. If any correspondence has been received with the check, it should also be kept.

When recording the deposits in the general ledger, care should be given to the type of revenue received. All like items should be coded to the same account.

Management of the organization should receive regular notification of the amount of the deposits made.

If a donor has restricted the usage of the contribution to a particular program, it will be necessary to record the amount as temporarily restricted. All allowable expenses incurred in connection with the grant and program will need to be tracked separately.

If you are on the accrual basis and the donor has agreed in writing to give a multi-year contribution, the full amount should be booked as income in the year the pledge is received.

## Credit Card Transactions

Many people will opt to charge a contribution or a fee for a service or publication given the option. The convenience associated with the transaction helps to facilitate the interaction with the organization. Further, with increasing online registration and purchasing, making credit card transactions available may be a necessity.

There are different options available. Regardless of the option chosen, fees will be charged by the transaction. The percentage charged varies by credit card vendor.

The credit card receipt is received by the organization. These transactions can be received through the mail or through emails generated by online submissions. Generally the organization will submit the transaction online to the credit card vendor. Once processed by the vendor, a deposit will be wired into the bank account of the organization. A summary report of the transactions processed will be sent periodically. These summary reports will need to be compared to the organizations records for the transactions submitted. The records from both the credit card vendor and the organization will need to be used to reconcile the bank account each month.

As online transactions become more prevalent, many organizations are choosing to have all transactions generated online sent directly to the credit card vendors. In this scenario, the credit card vendor receives the transaction directly, processes the transaction upon receipt and transmits the deposit to the bank immediately thereafter. A report is sent electronically to notify the organization of the activity. A paper summary of the transactions is sent periodically. The information relating to the payment is transmitted directly to the organization for processing.

## Sending Invoices

Invoices may need to be prepared for a number of reasons. Some organizations sell books or newsletters for a fee. Others require registration for meetings or bill for dues. In any event, all invoices should be reviewed by a person other than the preparer before mailing.

If the organization is on the accrual basis, invoices should be recorded in the general ledger when they are prepared. At this point in time, the debit is to accounts receivable (an outside party owes the organization money) and the credit is to revenue.

When the cash is received, the receivable is reduced and cash is increased on the books.

Copies should be kept of all invoices.

An aging list should be kept. In this manner, the amount of time it takes for an invoice to be paid can be tracked. Further, collection efforts can be started in a timely fashion.

If it is later determined that an amount will not be collected, the invoice and corresponding revenue should be written off. All amounts written off should be approved in writing by management.

## Other Cash

While writing checks and making deposits fall under the category of "cash," there are other activities involving cash.

The bank statements are received each month and must be reconciled to the general ledger (ie, QuickBooks).

Further, depending on need, a petty cash fund may be started to cover incidental office expenses. This fund should be for a minimal amount and should be used sparingly.

## Bank Reconciliations

If at all possible, an individual other than the person writing checks and making deposits should reconcile the bank account each month. Many organizations hire an outside accountant or bookkeeper to perform this function to increase the internal controls surrounding cash.

If the organization cannot afford to hire an outside accountant, the executive director (or the treasurer) should

receive the unopened bank statement each month. This individual should review all activity and be confident that all transactions are valid. The reviewer should initial the bank statement indicating his or her review.

Once the review takes place the appropriate individual should reconcile the account. All bank statements and the related information should then be filed.

## Petty Cash

It's amazing how much cash is stolen each year from petty cash funds.

Only one person should have access to the petty cash fund. At all times the cash and the receipts signed for withdrawals should equal the total of the fund in the general ledger.

The cash should be in a locked box and kept in a locked drawer or filing cabinet.

Every time an individual receives cash from the box, a voucher should be signed and placed in the box. The expense coding should be noted on the voucher.

If a receipt is obtained for taxi fare or the purchase of supplies, this receipt should be attached to the voucher.

When the cash in the box is low, the total of the vouchers should be determined and a check written for that amount. The check should be made payable to the individual in charge of the petty cash.

A summary of the expenses noted on the vouchers should be prepared and attached to the check copy. This summary will be the basis for recording the activity in the general ledger.

Under no circumstances should the petty cash fund be used to advance monies to employees in the form of loans.

## Payroll

There are many payroll services that will process the regular payroll, make direct deposits, prepare quarterly and annual tax filings and remit taxes due for a very reasonable fee. This is generally the most efficient and cost-effective manner for processing payroll and ensuring all tax requirements are met. Further, the payroll service is responsible for keeping current with changes to tax and benefit laws in all jurisdictions. And because an outside party is involved in the process, the controls surrounding payroll are enhanced and the risk of errors and/or misappropriation of funds are reduced immeasurably. With few exceptions, the use of a payroll service by a small organization is preferable to processing the transactions in-house.

It is important to obtain references when selecting a payroll service. Verify that the company is well established, has a reputation for accuracy in the reports it produces and remits taxes and returns in a timely fashion. Further, ask about the ease with which errors are corrected and the responsibility the payroll service assumes when payroll taxes are not calculated and reported properly. As the vendors include these services in their fees, the not-for-profit organization should not be held responsible for any penalties or interest resulting from the service's mistakes.

Once a payroll service has been selected, it is prudent to check with the Internal Revenue Service periodically to verify all taxes owed by the organization are paid currently and in full. This step will serve as a check in the event the payroll service does not remit all taxes when due, no matter what the reason.

All withdrawals from employees paychecks should be approved in writing by the employees. The following are common withdrawals that require signed forms:

- Federal income tax
- State income tax
- Pension withholdings
- Parking/metro
- Health insurance premiums

In addition, any raises received by the employee should be documented in writing and signed by the executive director or president of the board of directors.

The person who is in charge of payroll should notify the payroll service of any changes for the particular payroll.

The payroll summary issued by the payroll service prior to the payment of the payroll should be reviewed by both the payroll processor and a member of management or the board.

Sufficient cash should be available for automatic withdrawal by the payroll service for both the net salary and all taxes due.

Payroll is either recorded through the check register (QuickBooks) or by journal entry.

Support in the form of timesheets should be available to support the allocation of the salaries to the various functions (programs, grants, departments, general and administrative and fundraising). All time records should be saved.

## Time Sheets

Not-for-profits must record expenses on a functional basis. Salaries are generally the organization's largest expense. Allocating this expense to the various functions on an equitable and consistent basis is the key to properly reflecting the activity of the not-for-profit.

Time sheets are the most accurate method of allocating salary expense. Time sheets should be submitted by all employees for each pay period. The hours should be converted into percentages. The salary for the period is then allocated to the various functions based upon the resulting percentages.

Time sheets can also be used to monitor vacation, holiday, and sick leave.

All time sheets should be approved by a supervisor. If any changes are made, approval should also be noted on the actual time record.

The calculated amounts are then posted to the general ledger.

Fringe benefits and payroll taxes can be allocated based upon the time allocations. Fringe benefits include expenses incurred by the organization for such benefits as health insurance, the employer share of pension costs, and life insurance premiums.

The organization's overhead expenses can also be allocated using these percentages.

The allocations should be reviewed periodically to verify the accuracy of the entries.

Sample time sheets are included and can be used for allocating salaries and related expenses.

## Furniture & Equipment Assets

(a.k.a. Fixed Assets)

Depending on the size of the organization, most of the furniture and equipment purchased are considered assets and not expenses. Once an asset is recorded, its useful life is determined. A portion of the asset's cost is then expensed each year over the predetermined useful life using what is called a "contra" account. In the case of furniture and equipment, the contra account is called "accumulated depreciation."

Over time, the asset account and the corresponding accumulated depreciation account are netted together to determine the "book value" of the assets. The book value is used to determine the gain or loss when the asset is sold or abandoned.

The organization should establish a "capitalization policy." All items above an amount set by the organization are treated as assets, while items with a cost below the threshold are expensed when purchased. The threshold is not the same for every organization, and it should be based upon the size of the organization. For small organizations a limit of \$300 to \$500 might be appropriate.

Many organizations also need to maintain these records for filing personal property returns each year.

Periodic reviews of the fixed assets should be made to verify the list matches the actual items owned and used.

## Inventory Assets

Many not-for-profit organizations maintain an inventory of publications or other items held for sale over a long period of time. In these cases, the cost of the inventory item is capitalized as an asset and not taken immediately as an expense. Once the total development costs of the item are accumulated, the number of items owned is determined. A unit cost is then developed by taking the total cost over the number of items produced. Each time an item is sold, the unit cost of that item is expensed:

	DR	CR
Cost of goods sold	\$xx	
Inventory		\$xx

Over time the inventory balance should be reduced to zero.

If the item continues to sell, a second printing (if the item is a publication) might take place. It may be easiest to use the first-in, first-out method for determining unit cost. First, reduce the original inventory balance to zero, then use the unit cost for the second printing when reducing the inventory account.

If the item becomes obsolete over time, it is advisable to determine if the full value of the inventory is valid. If it is not, an allowance for obsolete inventory should be developed. The entry for recording the amount not being reduced due to sales would be:

Expense	\$xx
Allowance for obsolete inventory	\$xx

It is important to periodically count the remaining inventory and compare the total to the accounting records to verify the amounts agree. If there are missing items, the cause should be investigated. The accounts should be adjusted to reflect the new balance if necessary.

## Expenses

Not-for-profit organizations are required to track expenses by natural category and by function.

Natural categories include salaries, payroll taxes, rent, professional fees and office supplies.

Functional categories include program, general and administrative and fundraising expenses. Most organizations have more than one program and each of these should be tracked separately.

Generally, the internal interim statements are shown by natural category, with a separate statement of activities presented for each function. An overall statement then combines all the functional statements for the organization.

If an audit has been conducted, the audited statements will contain expenses on a functional level.

The Internal Revenue Service Form 990 requires both natural and functional expenses be reported.

All invoices should note the account coding on the invoice. The coding should be approved when the check is signed.

## Recording Other Transactions

The general ledger is the journal where all transactions are posted throughout the year and balances are maintained. To create a comprehensive and easily used general ledger, a chart of accounts is developed. The account numbers noted in the chart of accounts are the basis for sorting the information in the general ledger. Journal entries are the means for recording all activity in the general ledger.

## General Ledger

The general ledger documents all of the organization's transactions over the course of a year for all accounts. Every time a check is written, the transaction reduces cash and increases an expense account. Every time a check is deposited and recorded, cash is increased and revenue is increased.

The transactions are accumulated over the year and the totals maintained.

The account balances are the basis for all reporting activity. Account balances are sorted to generate all financial statements produced throughout the year.

Access to the general ledger should be limited to a very few individuals. Most transactions are posted automatically through receipts and payables modules. All modifications to the accounts should be made by posting a journal entry. This procedure ensures an audit trail will be maintained and all activity is recorded and monitored.

All accounts in the general ledger should be analyzed and/or reconciled each month to ensure the accuracy of the balances.

## Chart of Accounts

A well-developed chart of accounts is essential for:

Tracking the activity of the organization

- Presenting information periodically in a meaningful fashion to the organization
- Sorting activity by various functions, grants and programs

Most charts of accounts are developed using the following schematic:

1xxx Assets  
10xx Cash  
11xx Accounts Receivable

2xxx Liabilities  
20xx Accounts Payable  
21xx Accrued Expenses  
25xx Deferred Revenue

3xxx Net Assets

4xxx Revenue

5xxx Expenses

The use of subaccounts allows the organization the flexibility to present information in a number of ways. The subaccounts are a second set of numbers that, when combined with the account number, allow for sorting. For example, a printing bill may be for envelopes for the office and a brochure for a conference. Printing is an expense, so the full account numbers might be:

5350-2500 Printing, Conference  
5350-9000 Printing, General and Administrative

Expense coded to the conference are assigned to subaccount 2500. All of the expenses coded to that subaccount would then be accumulated for the year and a statement of activities (income statement) could be printed showing the results of the conference.

For QuickBooks, this is accomplished by using "classes."

Additional levels of subaccounts can be added for grants and other subsets of any particular subaccount.

## Journal Entries

Most transactions are posted automatically through the accounts payable and accounts receivable modules of the general ledger software owned by the not-for-profit. While these transactions are posted via journal entries generated by the software, the mechanism is not obvious.

Journal entries should be made for any transaction not automatically produced by the software. These entries often include payroll, reclassification of amounts already posted, reconciling items from the bank statement and allocations.

Entries should be made to reclassify previous posting and to correct errors. **NEVER CHANGE AN EXISTING TRANSACTION!** This is true even if the general ledger package allows you to do so.

The use of journal entries to correct prior transactions is necessary to create an audit trail. In this manner, all of the transaction made can be followed and traced to original documentation. All changes and entries should be reviewed by a second party and approved.

## Financial Reporting

It is important to report the financial position of the organization to the board of directors periodically, preferably monthly. Every organization presents this information differently, but a statement of financial position and a statement of activity should be the minimum presented.

During the year, a statement of activities noting the actual revenue and expenses for the month and to-date should be compared to the budgets prepared for the comparable periods. Any variances from expectations should be noted and explained.

The monitoring of the financial position of the organization in relation to the budget will allow the board of directors to take action if, for example, revenues are not sufficient to meet the projected expenses for the year. Steps can be taken to find other revenue sources or to cut costs.